Key accounting method considerations for 2012 returns

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In brief

Filing a federal income tax return can cause a taxpayer to adopt a method of accounting, both in general and with respect to a specific item. Accordingly, a taxpayer needs consider what accounting methods it intends to adopt prior to filing its return. Failing to consider adoption of an accounting method may result in reporting an item under an impermissible method, the inadvertent acceleration of income, or the inadvertent deferral of deduction.

Taxpayers may have differing objectives when selecting a method of accounting for a particular item:

- Taxpayers seeking to increase cash flow and decrease their current cash tax liability may benefit from accounting method changes that accelerate deductions or defer revenue.
- Taxpayers wishing to address current uncertain tax positions may file an automatic change in accounting with a return to correct an improper method and obtain audit protection.
- An accounting method change from an improper to a proper method of accounting may increase taxable income.
- Taxpayers generating NOLs may want to review tax accounting methods to maximize current-year NOLs to offset taxable income in prior years.

The number of accounting method changes that can be made without prior IRS consent has increased dramatically. A taxpayer that is not currently under IRS examination may file an automatic Form 3115, *Application for Change in Accounting Method*, at any time on or before the due date of the taxpayer's timely filed federal income tax return (including extensions). For calendar-year corporations with a six-month filing extension, the deadline for 2012 returns is September 16, 2013.

This WNTS Insight contains:

- a survey of some commonly overlooked elections that may need to be made with a federal income tax return,
- a list of common automatic changes that may decrease taxable income for the period, and
- a list of common accounting method changes that may increase taxable income for the period, but also may allow a taxpayer to begin reporting on a permissible method.

The discussion of elections and accounting methods is intended to be a general overview. Careful analysis is required regarding a particular taxpayer's specific facts to determine whether the desired change can be made automatically. Certain prerequisites for making a particular accounting method change must be satisfied.

In detail

Elections

Success-based fees

For taxpayers that make a timely filed election, Rev. Proc. 2011-29 provides a safe harbor for allocating success-based fees paid in business acquisitions or reorganizations described in Reg. sec. 1.263(a)-5(e)(3). To qualify for the safe harbor, a taxpayer must:

- Treat 70% of the amount of the success-based fee as an amount that does not facilitate the transaction;
- Capitalize the remaining 30% as an amount that does facilitate the transaction; and
- Attach a statement to its original federal income tax return for the tax year in which the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized.

Observations: It is important for taxpayers to understand the current IRS guidance with respect to this issue. In Chief Counsel Advice 201234027, the IRS took the position that non-refundable milestone payments generally are not eligible for the safe harbor in Rev. Proc. 2011-29. On April 29, 2013, the IRS Large Business and International (LB&I) division released a directive instructing LB&I examiners not to challenge a taxpayer's treatment of eligible milestone payments if certain requirements are satisfied on an original timely filed return.

The directive defines eligible milestone payments as milestone payments that are incurred by either an acquiring corporation or a target corporation and that are paid for investment banking services that are creditable against a success-based fee. Importantly, through its definition of milestone, the directive restricts eligible milestone payments to events that occur on or after (1) the date on which a letter of intent, exclusivity agreement, or other written agreement is executed, or (2) the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors (the "bright-line date"). (For more information, see WNTS Insight, "IRS issues favorable guidance on certain transaction costs," May 7, 2013.)

Section 172(f) losses

Section 172(f) allows taxpayers a 10-year carryback period for net operating losses (NOLs) to the extent 'specified liability losses' are taken into account in determining the loss for the year. Specified liability losses include:

- product liability losses, or expenses incurred in the investigation or settlement of, or opposition to, claims against a taxpayer on account of product liability; and
- any amount allowed as a deduction that is in satisfaction of a liability under a federal or state law requiring the reclamation of land, the decommissioning of a nuclear power plant, the dismantling of a drilling platform, the remediation of environmental contamination, or a payment under any workers compensation act.

Observation: The 10-year carryback is mandatory. If a taxpayer wishes to forgo the 10-year carryback for specified liability losses, it must file an election with a timely filed return. Note that a general election to forgo a carryback under Section 172(b)(3)(C) does not preclude a specified liability loss from being carried back 10 years.

Damage from Hurricane Sandy and other disasters

Taxpayers may claim a casualty loss under Section 165 for property deemed completely worthless to the extent not compensated by insurance. If an unreimbursed casualty loss has resulted from an identifiable event of sudden, unexpected, or unusual nature, taxpayers may claim a loss for partial destruction or reduction in value of property.

The cost of restoring damaged business property is not considered in calculating a Section 165 casualty loss. Instead, these costs are deductible either as section 162 costs or capitalizable under Section 263(a). If the expenditures merely restore the property to its condition before the event, the costs are deductible under Section 162 as a repair cost. If the expenditures materially enhance the value of the property, extend the useful life, or adapt the property to a new or different use, the expenditures are capitalizable.

The proposed and temporary "tangible" regulations under Section 263(a) would prohibit taxpayers from recognizing both a Section 165 loss and a Section 162 loss, which currently is permissible. However, those regulations would allow a taxpayer to forego a casualty loss in order to deduct under Section 162 the

costs to restore property to its ordinary efficient operating condition if a general asset account (GAA) election, discussed below, is in place.

If a taxpayer receives insurance proceeds or similar recoveries, the involuntary conversion rules under Section 1033 should be considered. Payments for loss of property generally reduce basis and only amounts in excess of basis are taxable, unless gain qualifies for involuntary conversion. Payments for lost profits are taxable currently.

Taxpayers may be able to apply the involuntary conversion rules to defer any gains resulting from payments for loss of business property in a federally declared disaster area to extent that property is replaced with any other business property within two years. These rules may provide an opportunity for a taxpayer to replace destroyed inventory with 39-year real property used in a trade or business.

Qualified disaster assistance property placed in service in 2012 is eligible for 50% bonus depreciation in the year the property is placed in service if an election is made. Certain property requirements must be met, including (1) the damaged property must have been substantially used in a disaster area with respect to a federally declared disaster occurring before January 1, 2010; (2) the replacement property must have been purchased and originally used after the disaster date; and (3) the replacement property must have been placed in service by the end of the third year following the disaster.

For more information, see WNTS Insight, "Tax relief options available for losses from natural disasters," July 24, 2013.

Bonus depreciation

Taxpayers should consider the following for 2012 tax returns:

- 50-percent bonus depreciation for qualified property placed into service through the end of 2012.
- 100-percent bonus depreciation for long production period property and certain aircraft placed in service through the end of 2012.
- Election to accelerate some alternative minimum tax credits in lieu of bonus depreciation.
- 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements.

Observation: Bonus depreciation is mandatory. A taxpayer wishing not to claim bonus depreciation must affirmatively elect out of the bonus depreciation regime.

General asset accounts

The temporary tangible property regulations provide increased flexibility for GAA treatment of property subject to section 168. Under the GAA rules, one or more assets having the same depreciation method, recovery period, year placed in service, and convention may be grouped and depreciated under MACRS as a single asset.

As a general rule, when a taxpayer disposes of property from a GAA, the taxpayer continues to depreciate the asset upon disposition. The taxpayer recognizes any gain as ordinary income in the amount of any proceeds. There is no recognition of loss – the asset is treated as having zero basis immediately before the loss, and depreciation of the GAA continues.

Observations: A GAA election offers certain flexibility. The temporary regulations allow taxpayer to recognize a loss at time of disposition by electing out of GAA upon a qualifying disposition, disposition of the last asset in an account, or disposition of all the assets in a GAA. This option to elect out of GAA at time of disposition gives the taxpayer the choice of whether to recognize a loss on the qualifying disposition or to continue depreciating the asset basis.

Although taxpayers must make a GAA election on Form 4562 in the year the asset or group of assets is placed in service, Rev. Proc. 2012-20 permits taxpayers to make a 'late' GAA election for property placed in service prior to 2012 by filing Form 3115. This late election is available only for a timely filed Form 3115 for the first or second tax year beginning on or after January 1, 2012.

For more information on GAA elections, see WNTS Insight, "Guidance on accounting for assets: What taxpayers need to know about single, multiple, and general asset accounts," January 7, 2013.

Accounting method changes to decrease taxable income

The following are accounting method changes that may provide taxpayers with opportunities to accelerate deductions or defer revenue recognition.

Self-insured medical accruals/ IBNR

Taxpayers may deduct incurred but not reported (IBNR) self-insured medical claims at the time such medical services are provided to the extent that, under the employer's self-insured medical plan, the medical service provider, rather than the employee, submits the claim for payment. This opportunity applies to medical IBNR accruals related to active employees, retired employees (i.e., FAS 106 liability), and worker compensation claims.

This opportunity may be particularly significant for taxpayers that currently

are receiving a benefit from the deduction of the Medicare Part D subsidy, which generally is recorded as a component of the FAS 106 liability for financial statement purposes. In tax years beginning after December 31, 2012, taxpayers no longer can deduct the cost of retiree prescription drug benefits covered by the Medicare Part D subsidy. Therefore, for eligible taxpayers, accelerating the IBNR deduction could result in cash tax savings.

Software development costs

Taxpayers that capitalize costs attributable to the development of software for internal use -- including costs incurred in developing websites or implementing enterprise resource planning (ERP) software packages -- may be able to file an automatic accounting method change to deduct those costs currently in accordance with Rev. Proc. 2000-50.

Uniform capitalization

Taxpayers that produce real or personal property, or acquire real or personal property to resell in the ordinary course of business, are subject to the uniform cost capitalization rules under Section 263A. Due to the complexity of the uniform capitalization rules, taxpayers may find that they are overcapitalizing costs. In many cases, a taxpayer can file an automatic accounting method change to properly apply Section 263A.

Depreciation

While there are many automatic accounting method changes related to fixed assets, the most common accounting method changes may provide taxpayers with the opportunity to change to a shorter recovery period, claim missed bonus depreciation, or begin to depreciate assets that have not been properly depreciated.

Advance payments

Taxpayers that receive advance payments related to certain goods, services, the use of intellectual property, computer software, or guaranty or warranty contracts and recognize income for federal income tax purposes when received may be able to defer income recognition for those payments to the next succeeding tax year in accordance with Rev. Proc. 2004-34.

Inventory valuation

Taxpayers with large inventory balances may be able to benefit from a change in their inventory valuation methods. Proper inventory valuation planning -- which can include changes to the timing of deductions related to subnormal goods, estimating inventory shrinkage, or changing to the lower of cost or market method -- may help taxpayers increase the deduction for cost of goods sold and therefore decrease taxable income.

Bad debts

Taxpayers that determine their book/tax difference for bad debts by analyzing the change in balance from year to year may be able to benefit from a change in method of accounting to deduct accounts receivable reserves related to specific customers that are either wholly worthless or partially worthless and charged off.

Prepaid payment liabilities

Taxpayers that currently are capitalizing prepaid expenses such as prepaid insurance, warranties, software maintenance, licenses, fees, and permits with a useful life of 12 months or less may have an opportunity to change their method of accounting to deduct those items when paid.

Cash-to-accrual method for a specific item

Accrual-method taxpayers sometimes may follow the cash method for certain items —¬ i.e., recognize a deduction for the item when payment is made, not when the item is fixed, determinable, and economic performance has occurred. Taxpayers may be able to file an automatic accounting method change to deduct those items using a proper accrual method. Examples of items that could be covered by this change include legal and other professional fees and environmental remediation costs.

Accounting method changes to increase taxable income

Changes from improper to proper methods

The following changes in method of accounting may benefit taxpayers that currently are using an improper method of accounting for the item by providing audit protection. In some cases, these changes will result in an increase to taxable income.

Uniform capitalization

Taxpayers that currently are using an improper method of accounting for their Section 263A costs -- such as applying a fixed percentage each year without having made a historic absorption ratio election or failing to properly capitalize certain costs -- may be able to file an automatic accounting method change to begin properly applying Section 263A.

Accrued bonuses

Taxpayers may take accrued bonuses into account to the extent the liability is fixed and reasonably determinable at year-end, economic performance has occurred, and payment is made within 2.5 months after year-end. However, some taxpayers may be accelerating incorrectly the deduction for accrued bonuses for which the

liability is not fixed at year-end. Taxpayers in this situation may be able to file an automatic accounting method change to apply properly the provisions of Section 461 to determine when the bonus should be taken into account.

Section 467 rental agreements

Taxpayers may be following their book method of accounting and taking rental deductions into account ratably over the term of the lease. However, if the rental agreement is subject to Section 467, taxpayers generally are required to accrue rental deductions for tax purposes in accordance with the rental agreement. An automatic accounting method change may be available, provided the rental agreement is not subject to proportional rental or at risk for constant rental.

Losses, expenses, and interest between related parties

Taxpayers that have transactions with related parties and that are not following the 'matching rule' in Sections 267(a)(2) and (3) may be taking deductions into account too soon. Taxpayers in this situation may be able to file an automatic accounting method change to properly apply the provisions of Section 267 and the regulations.

The takeaway

In preparing to file 2012 federal income tax returns, taxpayers should consider opportunities to elect various accounting methods. A taxpayer may inadvertently fail to make a beneficial accounting method election (either by failing to attach a required statement or by failing to understand the impacts of attaching such a statement). To the extent a taxpayer may wish to defer or include income in the 2012 tax year, the taxpayer may consider filing a request to change its existing method of accounting. Many of these requests to change a method of accounting fall under the automatic change procedures of Rev. Proc. 2011-14 and can be made for the 2012 tax year on a timely filed return.

Let's talk

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